POST-CRISIS ECONOMIC MODEL: RETURN TO KEYNESIANISM?

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Abstract. *Any major economic crisis causes significant changes in the mainstream macroeconomic models applied in most countries. After the oil crisis of the 70s and the imposition of monetarism, things have not changed significantly until the global financial and economic crisis that broke out a few years ago. In the aftermath, Keynesianism seems to be the most preferred economic current by the authorities, which is easily visible when looking at the change in their vision about regulation of the financial sector and the solutions to the crisis found, most often of interventionist nature. This paper aims to assess the appropriateness and possible implications of the adoption of Keynesianism, in a modern claimed embodiment.*

Keywords: *macroeconomic theories; economic model; economic crisis; crisis strategy; Keynesianism.*

JEL codes: E44, Q54, E43.

1. Introduction

No doubt the economic crisis is a phenomenon that no one wants to encounter. A crisis generally involves a rebalancing of some economic equilibrium that ws previously disturbed by external and internal factors. Economists have noticed quickly that economic crisis seems to recur from time to time, on a smaller or larger scale, in other words the existence of economic cycles was discovered. Since the Austrian school, all schools of economic thought have tried to explain why these crises occur and tried to find mechanisms that can be used to prevent or mitigate the possible negative effects.

The role of economics in a society is to indicate the best business model to follow. In other words, how we can properly organize the economic activity in order to avoid economic crises and to achieve a long-term sustainable growth. Very important in this issue is the role of the state

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(public authorities of any kind) in the economy. This is often where the schools of economic thought separate. Austrian school followers strongly oppose the state intervention in economic activity. According to them, the state can and must defend property rights and possibly provide a safe environment for private business to take place under normal conditions, but should abstain from interventionist policies of any kind. By contrast, advocates of interventionist theories claim that the State may have a positive and proactive role in an economy, if coherent measures are implemented to prevent market failures.

This paper is divided into five parts. After the introduction, the second part is dedicated to the “classic” Keynesian theory. This theory, although somewhat refined, is very popular today among many economists despite the fact that it was presented more than half a century ago. In addition to explaining the economic crisis, the great merit is that Keynesian school tried to develop a recipe that authorities should follow in order to prevent or to limit the negative effects of economic crisis. No doubt this means accepting the idea that the state may have a beneficial role in the economy and there are ways for it to intervene to suport the work of private agents with a positive outcome. Chapter 3 presents the main causes of the recent economic crisis. Although the crisis originated in the US financial sector, it quickly spread in the entire world and transformed into a full scale economic crisis, affecting all economic sectors. Chapter 4 proposes a brief analysis of solutions found by authorities around the world, from a keynesist perspective, and the possible implications of the adoption of Keynesianism as a mainstream economic model, with all pros and cons. The conclusions of this paper are layed down in Chapter 5.

2. Keynesian vision

The ideas expressed by John Maynard Keynes in his famous work entitled "The General Theory of Employment, Interest and Money" (first published in 1936) are still of great interest in that they are used by economic policy makers as arguments for the measures proposed and implemented to counter the crisis. This is because the Keynesian school of thought is one of the few schools that support a strong state intervention in economy and provide a coherent recipe on how to do this. According to Keynes, the classical theory represents only a particular case of his own theory, when there is full employment. Hence it is intitled "general" theory.

There are some key differences between the theories of Keynes and the rest specifically related to wage rigidity differences and liquidity preference.

The British economist shows that wages have certain rigidity to the changing demand for labor, and this creates the prerequisite for the appearance of involuntary unemployment. Wage rigidity is given in principle by the terms of contracts and labor laws that can still be found today in most economies. From this perspective, Keynesian theorists always prefer a somewhat higher level of inflation at the expense of unemployment. Basically, in a reasonable and steady decline in the purchasing power (by 1-2 percent per year), employers are given a breathing space in which wages may increase with inflation, if labor productivity is constant, above inflation if labor productivity increase or maintain the nominal wages and hence lower the wages in real terms, if labor productivity is decrease. Otherwise, in the latter case, the company can begin to accumulate losses which may ultimately lead to bankruptcy and unemployment. This is the main reason why some central banks in major economies such as the US Federal Reserve, have full employment among their objectives, along with maintaining prices stability. Keynesian theorists use this as an argument for an interventionist monetary policy in an economic slowdown in order to stimulate consumption.

In contrast to the Austrian school idea where natural interest is defined only in relation with time preference, Keynes introduces the concept of liquidity preference. The British economist defines 3 types reasons why individuals choose to keep cash[1]:

(I) transactional reasons – need of money for current transactions of personal and business exchanges;

(II) as a precaution – longing for security on current cash equivalent of a certain proportion of the total resources;

(III) speculative reasons – the objective of ensuring profit from a better knowledge of what the market will bring in the future.

For John Maynard Keynes interest rate is a phenomenon that involves a lot of psychology. Hence the phenomenon called the disciples of Keynes 'liquidity trap', or situation in which an increase in money supply will not change the real interest rates in the long term. It is a particular situation, investors believe that the price of securities is too high. Therefore they think that if they buy securities they will lose capital and, therefore, retains rather the money in various accounts or bank deposits. Under these

[1] Keynes, John Maynard (2009), *The general theory of employment, interest and money – preface by Paul Krugman*, Public Publishing, Bucharest, pp. 234-235.

conditions, the central bank can not use the standard tools of monetary policy to stimulate the economy, increase consumption and reduce unemployment. Keynes only exposes this problem but does not offer a practical solution. It would be preferable not to come to this. However, contemporary economists, followers of Keynesian ideas seem to have found some solutions to this problem, solutions that are found in quantitative easing measures applied for the first time in Japan in the early 2000s and internationally in most developed economies after the financial crisis in 2007.

After defining its concepts Keynes presents his own vision of the theory of economic cycles. Austrian school hypothesis that interest rates can play an important role in producing crises is accepted, but Keynes considered as the main culprit a sudden collapse of the marginal productivity of capital. Towards the end of periods of prosperity, investors are increasingly optimistic about future earnings of invested capital surplus could bring. Without an external action to stop this unfounded optimism at some time disappointments will appear. This time corresponds to the beginning of crisis. Panic is quick and investors choose to withdraw increasingly more from the real economy and to put their money somewhere safe (bank deposits in high trusted currencies, gold etc.). This will greatly increase the liquidity preference on account of the precautionary reason. The phenomenon described by Keynes is quite topical nowadays. Abrupt withdrawal of these investments in the real economy produces financing problems for large companies, which will generate significant losses. Once the sharp drop in the marginal productivity of capital occurs, this in turn causes a decrease in the propensity to consume, which will supply a further decrease in capital productivity (determined by lower demand this time), thus entering into a vicious circle of economic decline and unemployment. It is when the financial crisis becomes an economic crisis. All interventionist policies proposed by Keynes and his followers promoted by authorities worldwide will be based on the above reasoning. We can safely Keynes's explanation is different than that of the classical theories or the Austrian school related to the economic calculation problem (in which the entrepreneurs are influenced by expansionist policies of governments).

Consumption should be stimulated by all means to get out of this vicious circle and revive the economy. In the absence of intervention by the authorities, the crisis could be much tougher than necessary. However, because governments can allways intervene, economies should not enter into the trap of excessive exuberance and should not confrunt with economic crisis ever. Governments should not, under any circumstances, act pro-cyclical. Keynes and his adepts argue for interventionist monetary policy, designed to revive lending and help consumption.

John Maynard Keynes proves to be an optimist, believing that the state has a duty and a responsibility to protect the economy from crisis. Not happy with the idea that authorities should remain passive once the crisis has started and suggests some concrete measures of recovery. After all, if the state is the only trader who by his actions caused an economic crisis (as argued by the Austrian school), all the state can and should do is to act towards the reversal of this.

3. Reasons for the economic crisis

The recent economic crisis started as a financial one prior to the year 2008 and originated in the US housing market, although it expanded so quickly worldwide. Most economists accept the idea that the main culprit for this negative situation was the financial sector. US and European banks leanded money too easily to subprime debitors, usually in the housing market, through various systems of ensuring the loans in case of default. As these insurances were chep, banks were eager to support them, as profits were growing more and more. In theory, once the first payments were not settled, banks should activate the insurance and the collateral should be put on sale. However, between the time of receiving the money (and buying the house) and the first principal rates, usually the house price would increase and a new mortgage could be accesed (some of the loans had a grace period of years in which only interest would be paid). Basically most of the financial intermediaries lost their function of sound economic resource allocation and created beautifull dreams of easily achivabale prosperity. This could only have lead to a disaster.

Causes for this situation can be found in the lack of proper regulation of key parts of the financial intermediation sector, in the new corporate governance model of the recent years, or even in the fiscal and monetary policies of the governments worldwide which made great efforts to postpone the bursting of the bubble.

It is to be noted that economic science was deeply dominated by monetarist ideas prior to the 2007 crisis. Still, concerning regulation, one major economic theory stand out that was layed down in the 80's and failed to be implemented by authorities around the world. This is the theory of financial instability hypothesis of the American economist Hyman Philip Minsky. The theory can be regard as being of keynesism nature due to the support of government intervention (or central bank) in financial markets. It is one of the first theories of this kind, which analyzes the economic cycles including through existing institutional regulations. Minsky shows that financial markets are essentially unstable and that the state must intervene to correct this situation. For the purpose Minsky's road to instability goes through three phases[2]: Phase I – Stability, where funding is fully covered by income; Phase II – Speculative stage, where interest rates only are covered by revenues and the Phase III – Ponzi stage, where a company, in order to pay the interests owed, must use new funding that further increase its debt levels. The inherent instability of financial systems can lead to financial crisis and economic crisis. Minsky is committed to appropriate regulation of financial systems to prevent such slippage.

Even if Minsky's theory was not imposed in the 80s when it was exposed, it has taken a great interest among economists and politicians alike, after the 2007 financial crisis.

Regulation authorities often argued those days that corporate governance structure of major financial players is something private where no public/state authorities should intervene ever. Also, most of the regulation of the financial system consisted mainly in regulating deposit taking institutions, in order to ensure that those are fully safe. Instead, most of the other sectorrs of financial regulation was far less regulated, due to the investment component of them (it should generally involved a greater risk and greater possible profits). This made it possible to transfer the risk of default from one subsector to another. Authorities failed to involve in those situations were markets failed, specifically in corecting the moral hazard issues brought by the new corporate governance systems of many shareholders with small percentages of equity that made posibble CEO's to be more and more powerfull. Instead governments added to this bubble by trying to avoid its imminent burst through various means of stimulating the economy. This behavior could be described by Keynesyst adepts as procyclical.

The housing market was a major problem especially in U.S., however the European financial system became in turn vulnerable to it due to various financial instruments derived from those mortgages. Also, many European governments engaged in unsustainable debt in the periods prior to the financial crisis. This added to the negative effects of it. In periods of economic growth the Keynesian theory stronglly recomands governments to abstain from stimulating the economy even more by increasing the

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[2] Minsky P. Hyman (2011), *How do you stabilize an unstable economy*, Public Publishing, p. 420

governmental consum. Instead authorities should slowly make reserves in order to access them once the crisis starts. In Europe, prior to the financial crisis, most of the member states didn't observe at all the Maastricht criterias of sound public debt and public spending (public debt of no more than 60% of GDP and publis deficit of no more than 3% of GDP). This is also a procyclical behavior in Keynesian theory.

Also, the crisis overlayed to some historic economic problems in the EU, that could in turn have lead to individual, small scale, economic crisis of their own, but instead have lead to aggravating the negative effects and to hinder the responses of authorities.

4. The crisis nowdays

Once the crisis erupted, the first responses of public authorities were of tehnical nature, consisting of ensuring enough liquidity for the financial systems and economies to survive. Of course some authorities, especially in Europe, found this to be very challenging due to their actions prior to the financial crisis. For many, the financial crisis changed into a public debt crisis. This, together with the fact that agreeing with a comon response to the financial issues in Europe prove to be very challenging, are the main reasons that US recovered more quicly from the crisis.

In US, mesures that could be described as keynesist in nature, such as TARP programe, have been quickly implemented in order to save what's left from the financial system. Some belive that the crisis could very well been avoided if similar mesures would have been implemented prior to the banckrupcy of Lehman Brothers in 2008. However, TARP and similar programs prove to be very hard to explain to the general public even after the financial crisis, as it involved using public money to help large and private financial corporations. Also, it is these authors opinion, that if these mesures are not implemented together with others that would address the main causes that lead to this crisis, their impact would be insignificant on a long run. This would have also been hard to explain to the general public prior to the crisis. Similar mesures have been adopted in Europe, specifically in the Eurozone by ECB.

Saving the financial systems was one thing, but reviving the economies and gaining investor trust in its future was a different issue. Authorities around the world undertaken major efforts, financial and nonfinancial, to adress this. In the field of monetary policy, the rates were dropped systematically by central banks around the world. However, this didn't produced much positive effects due to a phenomenon described by

Keynes in its 1936 book and later named by its discipoles as liquidity trap. This is the case when long term interest rates remain high despite the shorth term interest rate being close to 0. In this case the classical monetary policy mesures no longer work to support economic growth and to limit unemployment. A solution to this problem, well supported by contemporany keynesist adepts is quantitative easing. This involves the intervention of central banks in some segments of the financial markets crisis not acting earlier. Specifically, the central bank buys bonds with long maturities in these markets to influence their yields and create fiscal space to stimulate the economy. Thus, central banks can continue to implement monetary policies, despite policy rates reached levels close to zero. This definetly creates additional monetary base, but not necesarry inflation, if central banks use money that would otherwise be locked by untrusting investors in the future potential on economies. Such measures were applied for the first time in Japan in the early 2000s, and with the outbreak of the financial crisis have been adopted in some of the most developed economies in the world, namely the US, Eurozone (especially in the very recent period) and UK. In the short term at least, the measures appear to be successful.

After doing what they can to save the financial systems and to limit the other negative effects of the financial crisis, governments worldwide began to analize the causes that have lead to it and, slowly, some mesures appear in the field of regulation and of public debt management.

5. Conclusions

Like all previous crises, the economic-financial crisis of 2007-2008 will undoubtedly cause changes in the mainstream economics. Today changes have already begun to be implemented by authorities around the world. They seem to embrace rather on principles outlined by Keynes and cyclical interventionist economic policies and those of Minsky on deregulation, in slightly refined theories. The main exponents of the current post new Keynesian economists are Joseph Stiglitz and Paul Krugman.

Stiglitz is a strong proponent of the legislation and therefore the instability of Minsky's theory of financial systems. The author has studied the situations where markets fail and considers there is always an issue of incentives and motivations. Support also taken from Keynes interventionist policies opposing solutions involving balancing budgets through austerity measures.

Paul Krugman, also a supporter of the ideas proposed by Keynes, says interventionism to stop the financial crisis including monetary policy. Liquidity trap described by Keynes in 1936 seems to have been solved by a new type called quantitative easing measures. This involves the intervention of central banks in some segments of the financial markets crisis not acting earlier. Specifically, the central bank buys bonds with long maturities in these markets to influence their yields and create fiscal space to stimulate the economy. Thus, central banks can continue to implement monetary policies, despite policy rates reached levels akin to zero. Such measures were applied for the first time in Japan in the early 2000s, and with the outbreak of the financial crisis have been adopted in some of the most developed economies in the world, namely the US, Eurozone and UK. In the short term at least, the measures appear to be successful.

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